

Internal Revenue Service  
**memorandum**

CC:TL-N-6989-89

Brl:HFRogers

date:

JUN 22 1989

to: Special Trial Attorney - Atlanta CC:SE

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject:

This is in response to your request for tax litigation advice dated May 19, 1989.

ISSUE

Whether [REDACTED]'s acquisition of customer lists as part of the purchase of [REDACTED] radio stations constitutes goodwill and is, therefore, nondepreciable.  
0167-0000

CONCLUSION

The customer lists at issue represent the customer structure of the business, are in the nature of goodwill and are nondepreciable.

FACTS

On [REDACTED], [REDACTED] of [REDACTED], North Carolina (subsidiary of petitioner, [REDACTED]) purchased [REDACTED] radio stations for \$[REDACTED]. Included in the purchase of [REDACTED] of the stations were customer lists of the stations' current advertising patrons. Based upon an outside appraisal of the purchased assets, \$[REDACTED] of the purchase price was allocated to the customer lists, as follows:

Station

Amount

[REDACTED]

\$ [REDACTED]  
\$ [REDACTED]

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As to the valuation of the customer lists, the appraisal contains the following information:

██████████ and ██████████ have developed approximately ██████████ customers who collectively represent most of the stations revenues. Sale of station time to local advertisers and sponsors was, for example, \$██████████ in ██████████ for both stations. Since total broadcast revenues from all sources was \$██████████, it can readily be seen that these customers play an essential role in the economics of the subject stations.

\* \* \*

There can be no doubt that the customer lists and related supportive information are a valuable asset of the subject company. They assist in generating approximately ██████████% of the stations revenues, enable the sales force to work efficiently and effectively, and permit reasonable budget projections. Without a list of customers and the related history of relationships existing between the stations and these customers, the stations would be in a very difficult position. The question is not, then, whether or not the customer lists have value, distinct from other intangible assets. It is our considered opinion the value of the lists can be estimated by making reasonable assumptions, and by considering what kind of expenditures would have to be made to create the same advantageous situation, if there were no lists.

There was a similar discussion for the other station as well.

In a Supplemental Protest dated ██████████, the petitioner stated (without evidence) that, within the radio industry, advertising is a high turnover, rapid customer replacement business. While a small core of from five to ten percent of a station's advertisers may remain with a station for many years, the remainder of any given year's advertisers will change within three to four years. Typically, from fifty to eighty percent will discontinue advertising in the immediately following year with the balance stopping within the subsequent two to three years. The petitioner prepared a chart which demonstrates that its experience with the customer lists purchased in ██████████, is in accord with this industry experience and is consistent with the useful life used by the petitioner on its filed returns.

On its income tax returns and public financial statements, the petitioner amortized these customer lists over a four year useful life. The examining agent disallowed all of the claimed amortization on the grounds that (1) the customer lists purchased along with the radio stations constituted nondepreciable goodwill and (2) the customer lists had an indeterminable useful life.

#### DISCUSSION

I.R.C. § 167(a) provides, in part, that "(t)here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-- ... of property used in the trade or business or ... for the production of income." Section 167 is not explicitly limited to tangible property and, accordingly, applies to intangible property as well.

Treas. Reg. § 1.167(a)-3 sets forth the general rule that if an intangible asset is known from experience or other factors to be of limited use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such intangible asset may be the subject of a depreciation allowance. However, the regulations deny the allowance for depreciation to an intangible asset the life of which is not limited. The regulations provide that the mere unsupported opinion of the taxpayer that an intangible asset has a limited useful life will not be sufficient evidence to support a depreciation deduction. Moreover, no deduction for depreciation is allowable with respect to goodwill.

Goodwill has been defined as "the expectancy of continued patronage ...," Boe v. Commissioner, 307 F.2d 339 (9th Cir. 1962), and "the expectancy that the old customers will resort to the old place." Commissioner v. Killian, 314 F.2d 852 (5th Cir. 1962). Goodwill is acquired by a purchaser of a going concern where the transfer enables the purchaser to step into the shoes of the seller. Balthrobe v. Commissioner, 356 F.2d 28 (5th Cir. 1966). The expectancy of continued patronage is the essence of goodwill. General Television, Inc. v. United States, 449 F. Supp. 609 (D. Minn. 1978), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979). Goodwill is nondepreciable as a rule because of the difficulties inherent in the computation of both its useful life and its value. Dodge Brothers v. United States, 118 F.2d 95 (4th Cir. 1941).

Traditionally, the Service's view was that customer lists and similar intangibles were inseparable from the customer structure of a business. They were, as a matter of law,

indistinguishable from nondepreciable goodwill possessing no determinable useful life. See [REDACTED], GCM 35,535, I-141-73 (Oct. 30, 1973); [REDACTED], GCM 34,262, I-3594 (Jan. 30, 1970).

As a result of the Service's loss in Manhattan Co. of Virginia, Inc. v. Commissioner, 50 T.C. 78 (1968), acq., 1974-2 C.B. 3, the Service reconsidered its position. The current position is expressed in Rev. Rul. 74-456, 1974-2 C.B. 65. The general rule is that customer lists represent the customer structure of a business, are in the nature of goodwill, and are nondepreciable. However, in an unusual case, where the acquired asset does not possess the characteristics of goodwill, a factual determination can be made and the asset depreciated if the taxpayer can establish that the asset:

(1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Rev. Rul. 74-456; Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).

As stated previously, customer lists generally represent nondepreciable customer structures. However, the factual determination whether an asset is inextricable from goodwill depends on the circumstances of each case. Numerous cases have now been tried on this issue and there has emerged a pattern of factual findings. These findings depend only partly on the objective nature of the asset; more important is the question whether the asset acquired is in reality tied to the customer structure of a business which the purchaser intends to continue operating.

Where the customer list is acquired from a business which was discontinued or where other substantial elements of goodwill were not acquired with the customer-related asset, courts have held that the asset was separate and distinct from goodwill. See Houston Chronicle Publishing Co., *supra* (depreciation allowed for subscription list acquired from publication being discontinued); Manhattan Co. of Virginia, Inc., *supra* (depreciation allowed for list of laundry home pick-up customers acquired from company discontinuing that aspect of its business); Holden Fuel Oil Co. v. Commissioner, T.C. Memo. 1972-45, *aff'd*, 479 F.2d 613 (6th Cir. 1973) (depreciation allowed for list of home fuel oil delivery customers acquired from company discontinuing that

aspect of its business); Midlantic National Bank v. Commissioner, T.C. Memo. 1983-581 (depreciation allowed for list of depositors acquired from bank that went out of business). This line of cases is correctly decided given that the assets for which depreciation was allowed were to be used for informational purposes by the businesses at issue, i.e., to solicit new customers, and were not purchased for the purpose of continuing an acquired business.

On the other hand, where the customer list is acquired as part of an ongoing business (characterized by no change in name, location or personnel), such that the taxpayer could be seen as stepping into the shoes of the seller and expecting continued patronage by an existing group of customers, the courts have concluded that the customer-related asset was either goodwill or was inextricable from goodwill. See General Television, Inc., supra (cable television subscribers' contracts, terminable at will, represented the expectancy of continued patronage which is the essence of goodwill); Finoli v. Commissioner, 86 T.C. 697 (1986) (taxpayer purchased customer structures, not subscriber lists); Westinghouse Broadcasting Co. v. Commissioner, 36 T.C. 912 (1961), aff'd on other issues, 304 F.2d 339 (9th Cir. 1962) (taxpayer purchased customer structure, not individual spot announcement contracts); Computing & Software, Inc. v. Commissioner, 64 T.C. 223 (1975) (although credit information had some separate value, the existence of substantial goodwill factors required a reallocation to increase the value of goodwill); Marsh & McLennon, Inc. v. Commissioner, 420 F.2d 667 (3d Cir.), aff'g 51 T.C. 56 (1969) (list of insurance expirations was part of goodwill of acquired business); Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969), aff'g 50 T.C. 952 (1968) (location contracts represented goodwill); Amsouth Bancorporation & Subsidiaries v. United States, 681 F. Supp. 698 (N.D. Ala. 1988) (deposit base of acquired bank was inseparable from goodwill); Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988), aff'g T.C. Memo. 1987-388 (insurance agency's purchase of another agency's insurance expirations was part of purchase of going concern and was inseparable from acquisition of goodwill).

There are two cases which fall outside the pattern. In Donrey v. United States, 809 F.2d 534 (8th Cir. 1987), depreciation was allowed for a newspaper subscription list acquired as part of an ongoing business. The Donrey result was reached by a jury and, on appeal, the three judge panel held that the District Court acted properly in submitting the question to the jury. The dissenting judge agreed with the government and stated that, as a matter of law, goodwill "includes the subscription list." Thus, we maintain that Donrey was affirmed only on procedural grounds and that the dissenting judge was correct that the District Court's failure to grant the government's motion for judgment notwithstanding the verdict should have been reversed.

In Citizens and Southern Corporation v. Commissioner, 91 T.C. 463 (1988), appeal docketed, (11th Cir. Feb. 23, 1989), the Tax Court examined whether a bank core deposit base could be depreciated. The majority of the Tax Court concluded that a bank core deposit base had an ascertainable cost basis separate and distinct from goodwill and that the deposit base had a limited useful life which could be ascertained with reasonable accuracy. The majority held that the taxpayer was entitled to allocate to the deposit base an amount equal to the present value (on the date of acquisition) of the difference in cost between the acquired core deposits and the next least expensive market alternative for borrowing equivalent funds and to take a depreciation deduction based on the allocated amount.

Therefore, the majority found core deposits represented the availability of low cost funds, rather than deposits from its customers that the bank expected to retain for an extended period of time. There were two concurring and two dissenting opinions which reflect a considerable division of opinion. We are hopeful that the appellate decision will bring this case back into line with prior opinions. Additionally, the Tax Court's analysis cannot be used for customer lists since they are lists which identify customer structures (including the expectancy of continued patronage), rather than customer bank deposits which the bank expects to retain for an extended period of time. Therefore, customer lists cannot be redefined as available low cost funds as the Tax Court viewed core deposits in Citizens and Southern.

The rationale for the Service position that customer lists are nondepreciable as a matter of law can be summarized as follows:

- 1) The customer list represents "customer relationships" or the "customer structure" of the acquired business. As such, the intangible asset is indistinguishable from goodwill;
- 2) The value assigned to the customer list represents the measurement of the continued patronage of the acquired business' customer and is, therefore, goodwill; and
- 3) The customer list cannot be transferred apart from the transfer of the acquired business' goodwill.

We view the facts in the instant case as squarely in line with the cases which have held that customer lists are inseparable from goodwill and, therefore, nondepreciable as a matter of law. Further, the facts in the subject case present an appropriate litigating vehicle with which to advance the Service

position. [REDACTED] merely stepped into the shoes of the seller of an ongoing business. There was no stop in services or changes in personnel or location. The acquired business was in sound financial condition. The name of the acquired business was not changed.

If you have any further questions, please contact Helen F. Rogers of this office at FTS 566-3442.

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